CHAPTER 1

Making Money in Small-Caps

By almost any benchmark, small-cap stocks are the new value on Wall Street—and, increasingly, on its counterpart in Canada, Toronto's Bay Street, where some of the highest fliers of the low-priced stock world trade. What's more, in the years to come, you'll find these hidden gems, these proverbial diamonds in the rough, leading the indexes higher. I say this with barely concealed enthusiasm because, given the current beaten-down investment climate, it is inevitable that the cycle will change and the small-caps will explode higher.

Small-caps present a ground-floor opportunity—one that doesn't present itself every day. We all know that expectations are the highest at market tops. But right now, because market expectations are less than stellar, the conditions are ripe for the astute investor to gobble up low-price shares in dozens of beaten-down companies whose stocks are selling significantly below their true value. Cheap stocks, depressed stocks, penny stocks, small-cap stocks—whatever you want to call them, they are the next new big thing. The question is: Will you get on at the ground floor, or would you prefer to wait until these shares sell at penthouse prices?

SMALL-CAPS: THE NEXT BULL MARKET

It's a simple premise: With the indexes already climbing to new highs, it is not a matter of *if* the next bull market will see a surge in small-cap stock prices, but *when*. Looking back, one can see plenty of historical evidence for continued explosive growth among low-priced stocks. Small-caps, for instance, have traditionally enjoyed spectacular gains compared with their higher-priced cousins. Over one recent 10-year period, small-caps outperformed larger-cap stocks by a whopping ten-to-one margin. As for percentage gainers, the small-caps invariably lead the pack. The top ten low-priced gainers increased in value by more than 261 percent over a recent year. During an identical period, the top ten S&P listed stocks gained just under 15.5 percent.

When you consider the numbers involved, you can see why investors prefer low-priced stocks. From an investor's standpoint, you can take $5,000 and buy 5,000 shares of a $1 stock (commissions excluded) or 100 shares of a $50 stock. A 50-cent gain in the $1 stock would generate $2,500 in profit. That's a 50 percent gain. The same 50-cent gain on the $50 stock, however, would generate just $50 in profit. To double in value, a $1 stock has to rise to only $2. To generate the same percentage gain, a $50 stock has to trade at $100 a share. Now ask yourself which is more likely to happen: a $1 stock going to $2 or a $50 stock going to $100?

The reluctance of investors to jump on the bandwagon of a higher-priced stock explains why successful companies often have two-for-one splits. By offering twice as many shares to their investors, companies can enjoy greater investor participation by halving the share cost from, say, $60 a share to $30 via a stock split.

Investor enthusiasm for small-caps is likely to grow for many reasons beyond the price alone. Smaller companies are more likely to be start-ups or in the early stage of their development. This allows greater upside potential. A seasoned company, on the other hand, has far greater difficulty in achieving the same level of growth as a new, smaller company. Accordingly, low-priced stocks can often double and triple in value while their big brothers have trouble attaining even a double-digit gain. It is not uncommon to see the stock of smaller companies increase in value by many hundreds of percent.

During uncertain times, however, these lower-priced companies are often ignored. People prefer something tried-and-true, perhaps a blue chip that pays steady dividends. The result is a lot of hidden value in the lower-priced issues. These are the shares we want to go prospecting for, sort of like digging up gold that lies hidden in the mine. Not surprisingly, many small-caps are indeed mining companies, their resources literally lying in the ground.

I found just such a stock several years ago when a friend recommended a little-known company trading on the Toronto Stock Exchange. Though its corporate offices were headquartered in Vancouver, British Columbia, First Quantum Minerals (FM.TO) was really an undiscovered asset-rich little copper-mining company in Zambia (see Figure 1.1). Its hidden value lay in its vast reserves still underground. The shares were then changing hands for just 80 cents Canadian. Within three years, a bull market in copper pushed the stock to more than $48 a share!

Although this stock has already made its run, you can be certain that many similar opportunities are out there. Moreover, the opportunities are not limited to just one sector or another. You might seek your fortune in mining or biotech or technology or dozens of other industries. There truly are opportunities everywhere!

SEPARATING THE WHEAT FROM THE CHAFF

In the pages that follow, I spell out a number of concepts and theories on how best to identify value in small stocks. I cover in detail the two most popular approaches to traditional stock market interpretation: fundamental and technical analysis. My approach is to find bargains based on price,

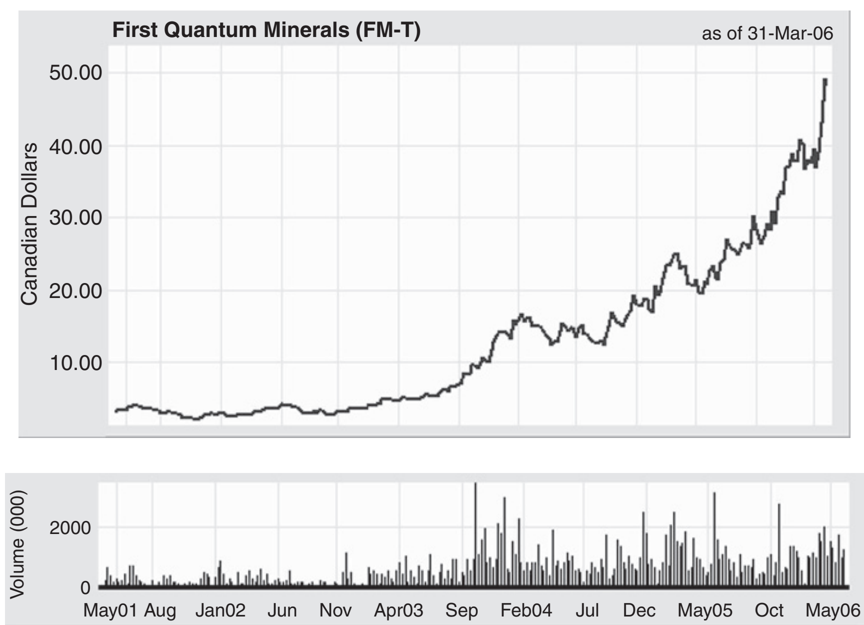

FIGURE 1.1 First Quantum Minerals
Courtesy of the Toronto Stock Exchange.

value, and market activity. Whether you call it buying low, buying cheap, or simply buying depressed stocks, you want to find the overlooked company that promises an impressive return. We are not looking to flip stocks. Your time horizon could be several weeks, months, or even years. It all depends on how you can best capitalize on a legitimate growth spurt. For investors who know where to look, the highest profits come from small companies with big prospects, so that is the area where we will concentrate our efforts. I hope you will find the guidelines easy to understand and implement.

You will learn how to evaluate and interpret performance: the best time to purchase—or sell—a given stock. You will also learn why some stocks fail to live up to their promise. You will discover the hidden pitfalls of investing—the most common mistakes made by just about every investor.

Over the years, I have looked at literally thousands of stocks. There are many stocks that, while they may look promising at first glance, upon analysis, don't measure up to our chosen criteria. We look at them from both a fundamental and a technical viewpoint. From a sample of more than 1,000 stocks, for example, you might select just 50 for additional analysis. This number then might be cut in half, and you'll ultimately end up with 15 to 20 high-probability selections. This task can be daunting, but it is necessary if you are to capitalize on the best opportunities.

What are the key criteria? You want to find small companies trading at attractive prices. So you might limit your study to stocks trading under $10 a share. You want the company to enjoy some measure of participation from the investment community. So you will take trading volume into consideration.

I try to avoid initial public offerings (IPOs) because they lack the price history that is crucial in making intelligent decisions. This is not to say there aren't wonderful opportunities in the IPO market. There are. But you must know what to look for and when to take the plunge. You'll find additional information about getting started in the IPO market in Chapter 5.

Then there are the all-important fundamental factors. What exactly does the company do? Does its business plan allow it to grow exponentially in the months and years ahead? Is its management sound? Does management have the experience to get a relatively new start-up off the ground? If the company has been in existence for a period of time, are there reasons for it to take off in the future? And so on.

On a technical level, a whole host of technical indicators measure whether a stock is performing correctly. I don't necessarily rule out an underperforming stock. But we'll want to know why the stock cannot pass muster on these vital benchmarks.

Learning what to look for takes time. Once you understand the key guidelines to stock selection, however, you'll be able to make both sound and quick decisions concerning a stock's viability.

HIDDEN VALUE: THE SMALL STOCK'S SECRET WEAPON

If you want to make a small fortune, goes the old saying, start with a large fortune. In the world of small stocks, however, the key to making a small fortune is hidden value. What does the company have that could make its shares explode in value? In the case of First Quantum Minerals, the key was its vast copper reserves in a country set in the middle of political strife. Although the Zambian authorities have become increasingly pro-business in recent years, the same could not be said for some of its neighbors, notably the Democratic Republic of the Congo (DRC). Just the possibility of a political coup from a hostile neighbor can understandably scare off investors. No one wants to invest in a company that might one day be nationalized.

At times, the clues to a stock's potential can be subtle. While researching First Quantum, I learned that despite the possibility of neighboring government intrusions, the company had a good record in dealing with its employees. It operated a small hospital, for example, to provide its workers with health care. Didn't it make sense to conclude that a company that cared for its workers might also look out for the interests of shareholders? No fly-by-night operation would go to the trouble to construct a hospital. This company planned to be around for a while—truly, a positive sign.

At about the same time, an interesting article appeared in the *New York Times* that cited a surge in the growth of private golf courses in Southern Africa. What exactly is the connection between golf courses and mining? It seems that during the political turmoil of earlier times, private golf courses had been shut down as their members fled Africa. More often than not, these private clubs' membership included the managerial class of Africa's leading firms. These management professionals were precisely the people needed to generate business revenue, yet they had been driven out of the region because of political unrest. Now they were returning. According to the *Times* article, the new pro-business climate was generating renewed interest in leisure activities in the region, golf being just one of them. With the European managerial class returning, a new day had broken.

This change was subtle perhaps, but it didn't take me long to draw the logical inference. One, here's a company with vast undeveloped resources. Two, the company actually seems to take an interest in the welfare of its employees. Three, the influx of quality management professionals was on the upswing, as evidenced by the boom in local golf courses.

The fourth major point was as yet unknown. What was the potential for metal prices—specifically, the price of copper? If this company had what it promised, everything was in place for a phenomenal investment. The worldwide demand for the red metal soared. Share prices for the Zambian copper company went from under a buck to over $26!

If you are looking for a similar bonanza, you have to sense the potential before it becomes evident. One place to look is at biotech start-up firms. Though obviously fraught with risk (almost all of these firms have no profits in the beginning), these companies often double or triple in price when a breakthrough drug or diagnostic cure is introduced or, better yet, approved by the regulatory authorities. Take the case of one such stock I owned last year. The biotech firm Biomira (BIOM) surged from 80 cents to close to $3 a share almost overnight following a favorable ruling on one of its drug studies (see Figure 1.2).

Another biotech Canadian firm, DiagnoCure (CUR.TO), specializing in the development of proprietary diagnostic tools, likewise had a meteoric rise, soaring from $1 to over $6 a share, when it introduced its proprietary prostate test kit (as shown in Figure 1.3). At the same time, the Quebec City–based Canadian firm partnered a deal with San Diego–based Gen-Probe, which specializes in distribution of medical diagnostic equipment. Just recently, Gen-Probe has become a darling of Wall Street, making new highs day after day. Can it be long before little DiagnoCure is likewise discovered?

These companies are examples of what an intelligent investor looks for in terms of value. Timing is critical if you are to participate in the lion's share of the profits available in these and other stocks. But they illustrate

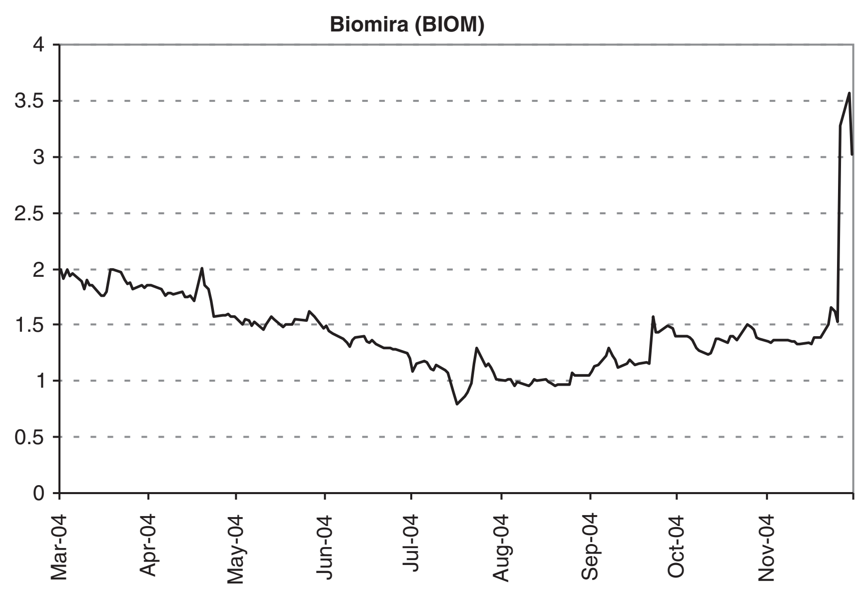

FIGURE 1.2 Biomira's Surge

FIGURE 1.3 DiagnoCure's Rise
Courtesy of the Toronto Stock Exchange.

the potential—*if* you are selective when you buy and sell. At the same time, remember that despite good intentions, even the best companies often encounter roadblocks and obstacles. Rare is the investor who hasn't been knocked around and blindsided by an unexpected earnings report. Even the best companies underperform occasionally. So the road to profitability is not always a carefree course. If you concentrate on finding hidden value, however, you will find that what a company has often prevails in the end.

THE VALUE INVESTOR

Not long ago, I spoke with a friend of mine who is a private investor. His strategy: buy little-known companies with good fundamentals. A self-described value investor, he understandably wants to buy before a company's story gets out.

"It always makes me a little nervous," he explained, "if there is a lot of interest when I buy."

His strategy is to buy shares in small, yet-to-be-discovered companies that have verifiable resources (mines and oil companies), emerging technologies (biotechs), or simply a rock-solid balance sheet in a hot sector (gaming). He may contact the CEO of a potential investment company and invite him over for lunch. When the CEO of a small company sees that someone is about to invest several million dollars in the company's stock, you'd be surprised how receptive he can be to such an invitation. One such investor brings not just his personal capital to the table but also the capital of his well-financed friends. He supports the stock in the truest sense of the word.

Over lunch, the conversation invariably turns to the company's hidden value.

"Mr. CEO," the investor might say, "I've been looking for an opportunity and was wondering if you were interested in greater investor support."

"Who wouldn't be? The company is hardly on the radar screens of most brokers right now."

"I understand, Mr. CEO. But without disclosing any inside information, what can you tell me about your mining operations at Silver Lake Ridge? What are the prospects, in your opinion?"

In this fashion, the sophisticated investor can gain a greater handle on the company, see firsthand whether the company's story seems to make sense, and see if the two of them make a good fit. An enlightened management will make an effort to accommodate such a request from a credible source.

Why?

There are many reasons. As the holder of perhaps hundreds of thousands of cheap shares, the CEO wants to get the company's story out there in front of the investment community. He may have a new IPO planned. He understands that his interests and the shareholders' interests are the same.

From the investor's standpoint, there may be questions he needs answered before he commits his capital. At this stage, the discussion might be just a fishing expedition. The investor might just want to get to know management first. Can he trust these guys? Do they seem upfront and honest? Do they have what they say they have? Are they just blowing smoke? What, in short, is the hidden value?

TIMING

Even the best stocks make lousy investments if you buy them at the wrong time. To decide when to buy—and sell—you must rely on technical price patterns. More art than science, technical analysis enables the astute investor to uncover a sleeping giant long before it springs awake. Several months ago, I performed a cursory analysis on several dozen stocks. Knowing my criteria, I quickly sped through the stock charts. Suddenly, I found what I'd been looking for: the classic bowl or saucer pattern. According to Figure 1.4, this little-known petroleum company was screaming, "Buy! Buy! Buy!"

By almost any measurement, little Abraxas Petroleum (ABP), trading on the American Stock Exchange, was poised to run. The chart pattern was a classic buy. The stock had done all the necessary sideways work. The next move was up. I bought it immediately.

Trading under $1.50 a share, the stock doubled in value in three months' time. But that was just the beginning. It later traded up to $9.25 a share!

You have probably never heard of little Abraxas Petroleum and many of the other stocks that might be discussed in this book. But ask yourself this: When was the last time that Disney, IBM, Motorola, or Lucent—not to mention dozens of other high-profile shares—doubled in value in three months? Granted, these stocks were all darlings of Wall Street at one time. Lucent, which often leads the most active list, once traded over $80 a share. More recently, it has traded as low as $2. Rather than concentrating on the past glories of these well-known companies, why not seek out

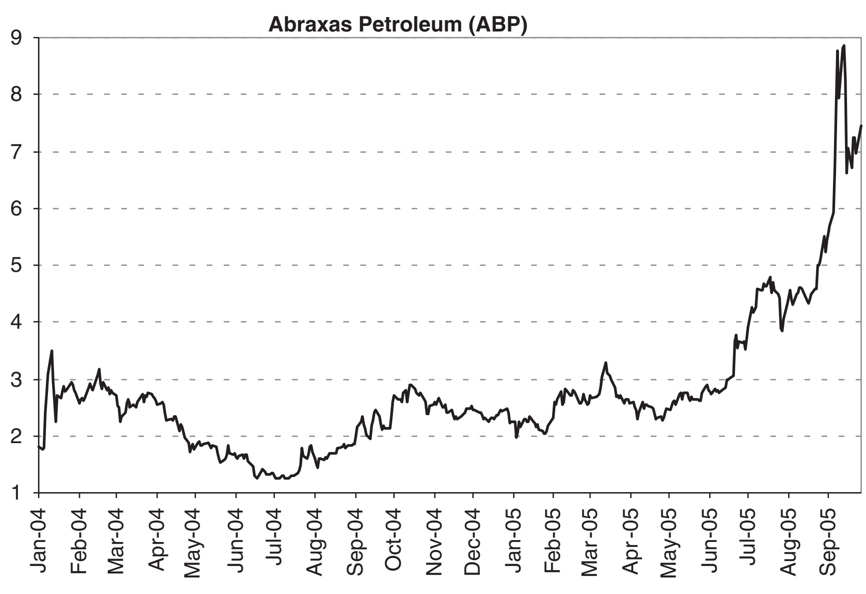

FIGURE 1.4 Abraxas Petroleum: Ready to Buy?

the new—and yet undiscovered—low-priced shares that might be in the headlines in the months and years ahead?

Small stocks routinely make percentage gains unheard of among larger stocks. In the past 12 months, the large-cap Dow stocks gained just 5 percent while the Russell 2000 index, which tracks the performance of small-cap stocks, registered a healthy 24 percent gain. Moreover, to the knowledgeable investor, they signal not just when and where to buy but exactly where to take profits as well. It's all a question of timing.

Investors are a remarkably impatient lot. When they purchase a stock, they often think that the stock should understand that their investment should trigger rapid price gains. In the case of low-priced stocks, which are often in turnaround situations (often that's why the price is low), a company's shares may drift lower for months and even years before the company's fundamentals change sufficiently for a sustained rally to begin. A distressed stock may take as long as one or two years forming a bottoming pattern on the charts. The good news is that this bottom pattern provides a strong foundation for the subsequent rally. But the investor must be patient.

A stock does not rise in value in isolation. Even the best companies are often beaten down by a bad market. Factors like high interest rates, deteriorating corporate profits, and a government with a reckless fiscal policy can all wreak havoc on the stock market. The thing to remember is that the market is cyclical. So today's dog is tomorrow's high flier. Anyone familiar with the doom-and-gloom mentality of a bear market can readily see how the fundamentals often seem to change overnight. A quick glance at the headlines of the *Wall Street Journal* often reveals this pattern. Last week's "Stocks Plunge on Interest Rate Rise" often becomes this week's "Stocks Soar on Improving Corporate Profits" headline.

The time element is crucial to sensible investing. Profitable investing requires having the vision to allow time for your investment to work out. With time on your side, you can readily grab shares at bargain basement prices—shares that are being sold by impatient and uninformed individuals who see the market as an alternative to this week's lottery.

SMALL STOCKS, BIG PROFITS

A low stock price enables you to purchase a lot of shares, often at a discount from the stock's true value. Several years ago, a friend called and said he had purchased a million shares of a little-known mining company then trading at $1 Canadian on the Toronto Stock Exchange. Virginia Mines (VIA.TO) was the classic asset play. It was a resource company poised to run higher on a boom in commodity prices. The stock is currently trading over $15 a share—not bad for a company that I was able to pick up for close to a buck Canadian, about 76 cents U.S. at the time. See Figure 1.5.

Not long ago, we stood outside his waterfront home on the West Coast of Canada, surveying his lawn that swept down to the sea. It was a truly magnificent setting, something right out of *The Great Gatsby*.

As we were enjoying the view, my friend turned to me and asked, "Do you remember Virginia Mines?"

"Yes. You were the one who first recommended it to me."

"Little Virginia paid for most of this house."

Here was a small stock that had provided a big payoff. When you buy with hidden value in mind, your profit is assured—if not today, certainly tomorrow or in the near future. The profit exists at the time you buy. That's why the hidden value approach is so profitable. Using this formula, you can string together a series of impressive wins. Not long ago, I reviewed a series of buys and sells that this same friend had recommended over a period of eight years. There were six prime selections that met all the technical and fundamental criteria. They were all winners. And of course, they all started out as small, underpriced stocks.

FIGURE 1.5 Virginia Mines: Classic Asset Play
Courtesy of the Toronto Stock Exchange.

I recently read an insider stock report that claimed you can't make money buying stocks under $5 a share. In fact, according to this insider, most stocks under $5 never rise above that price. Among the many misconceptions about the stock market, this attitude of avoiding low-priced stocks at all costs is just one of them. Another is the notion that price/earnings ratios are particularly helpful in selecting a stock. Indeed, some of the best low-priced stocks don't have any earnings at all—yet!

Two stocks that readily come to mind are Taser International (TASR) and Sirius Satellite Radio (SIRI) (see Figure 1.6). Neither stock had earnings when they were low-priced stocks, yet they both skyrocketed in price! Wouldn't you prefer getting in on the ground floor before anyone else has even heard of the stock?

Look how Taser stock traded from 50 cents to $9.

PAYING PENNIES, SELLING FOR DOLLARS

Selecting low-price stock opportunities requires looking for unique situations or promising fundamentals. Several years ago, I found a mining stock that had traded close to $4 a share in the March 2000 Internet bubble. Decimated since then, the stock tumbled all the way to 6 cents, where it languished. By the time I discovered this stock, it was changing hands for 30 cents a share—a fivefold increase. It later rose to $2.18 a share.

When you have an emerging asset play, the hidden value is often literally underground. In a situation like this, the company's potential is often underestimated or overlooked by the investment community. This is especially true when you have a low-priced stock because these so-called speculative issues are beneath the dignity of the Wall Street pundits who want you to buy Microsoft, Motorola, and other sure-thing stocks. The Wall Street crowd won't even look at one of these speculative stocks for fear an enterprising attorney down the road will accuse them of steering their clients toward reckless investments. Ironically, these stocks offer precisely the opportunity that is most welcome.

Pardon the pun, but finding a mining company such as this one requires a little digging. Again, a friend who specializes in uncovering opportunities in little-known gems first uncovered the potential of this stock. An initial look at the company wasn't particularly positive (see Figure 1.7). Trading at just 15 cents Canadian, Northern Orion Resources (NTO) engineered a reverse 10-for-1 stock split. Normally, a reverse stock split is a red flag to an investor because it suggests that a company is about to be delisted on account of a low share price. The reverse split immediately raises the

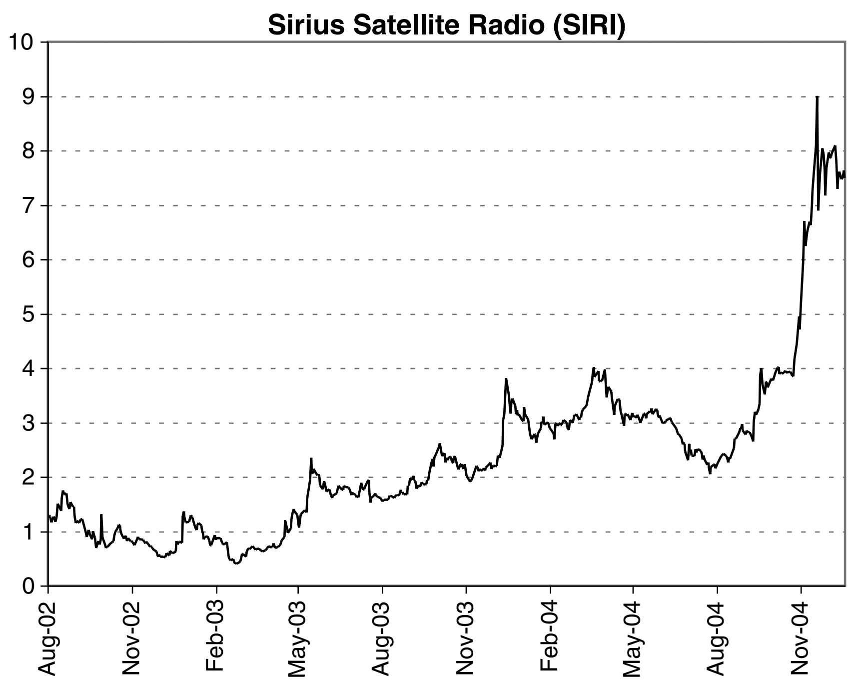

FIGURE 1.6 Taser International and Sirius Radio

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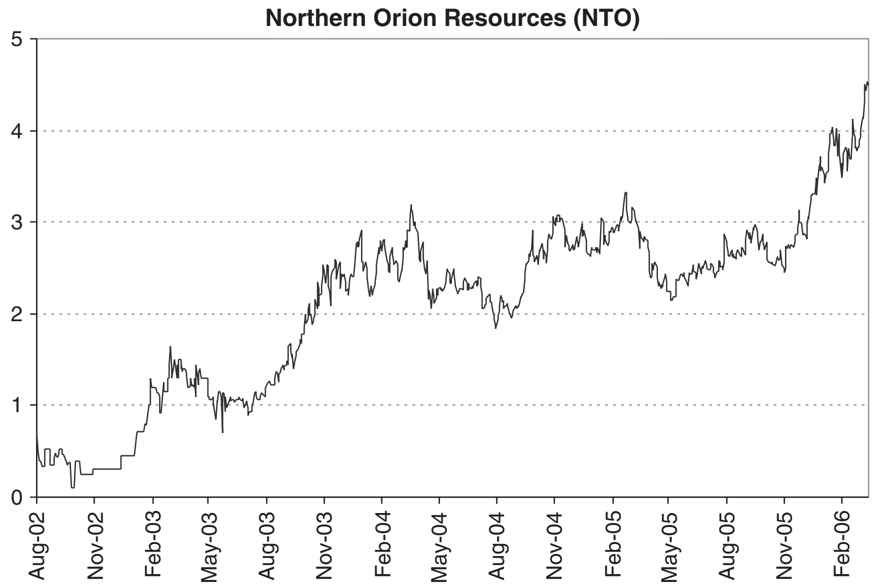

FIGURE 1.7 Northern Orion Resources

price, but typically the shares fall in value after this face-saving maneuver. In this instance, the reverse split meant the 15-cent shares were now valued at $1.50—but, remember, there are only a tenth as many shares. Instead of owning 1,000 shares at 15 cents apiece, the shareholder now had only 100 shares valued at $1.50 each. (Note that Northern Orion shares were subsequently listed at the American Stock Exchange; Northern Orion was later bought out by Yamana Gold.)

This little-known copper and gold producer, however, was not your typical reverse-split candidate. A glance at the fundamentals revealed a company on a positive growth spurt. The company had recently acquired 12.5 percent of the Alumbrera Mine in northwest Argentina. Partly because of the collapse of the Argentinean peso, this was one of the lowest-cost mines in the world to operate. At the same time, the worldwide demand for copper surged. The company's 2004 share in Alumbrera was 49 million pounds of copper and 71,000 ounces of gold. Even greater amounts of these metals have been discovered in the Alumbrera Mine since then.

So profitable did their operations become, largely based on the Alumbrera Mine windfall, that Northern Orion had a corporate nest egg of more than $140 million. Eighteen months after the reverse split, the shares traded over $4, creating an impressive reward for the shareholders as well as the company. I want to stress that I have long since taken profits in this little gem. But there are other promising situations on the radar screen.

EVERY STOCK HAS ITS STORY

As you can probably tell by now, every stock has its story. I've tried to highlight just a few here. The key, of course, is finding out the story before it becomes widely known. You'd be surprised how prosaic some of the biggest success stories are. Who would have thought that a chain of hardware stores would morph into Home Depot? Or that the notion of discounting would create a Wal-Mart empire? Or inexpensive hamburgers, the McDonald's chain? I am not saying, of course, that the investment world isn't full of pitfalls for the unsuspecting investor. Mark Twain once quipped that a mine was a hole in the ground with a liar standing on top. The same might be said of numerous dry oil-drilling ventures, as well as many other areas where investors have lost money in the past.

You truly don't always know what you have when you begin to investigate the prospects of a given investment. But separating the wheat from the chaff is what this story is all about. The payoff comes when you discover a treasure trove of unrealized opportunity. That's our goal here.

In the pages that follow, you will see that I rarely concentrate on traditional guidelines for picking successful stocks. There is a pattern for finding the kind of hidden gems we are talking about here, but you won't find the analysts on CNBC discussing these stocks. They are, frankly, too speculative for the television pundits, who are more interested in covering familiar companies like Disney, General Motors, IBM, and Coca-Cola. I am confident in saying that these high-priced, seasoned stocks will never register the percentage returns of low-price stocks. By the time a stock becomes a household name, you can bet its story has entered the folklore of the investment community. We are looking for the untold story, the story yet to be highlighted on the front pages of the *Wall Street Journal*.

This iconoclastic view is not shared by everyone. But for aggressive investors who don't want to spend their investment hours chasing small returns, this focused and specialized approach makes sense.

Finally, you must also understand that finding the best opportunities requires hard work—and a bit of luck. Let's get started.